



SPOTLIGHT | MARCH 2020

A COVID-19 FRAMEWORK FOR MARKETS

Key points

- The 2002-2003 SARS outbreak framework that most, including ourselves, were drawing upon to anticipate the trajectory of the COVID-19 coronavirus outbreak requires an adjustment following the failure of authorities to contain the contagion to the Asian continent.
 - While an extended economic demand shock itself is problematic, the potential for a damaging credit shock as a second round effect should not be underestimated by investors. Even modest credit shock scenarios risk a further 15-30% declines in regional equities.
 - Recent central bank rates cuts are a necessary step but not themselves sufficient to avoid a credit shock. We believe that timely and aggressive fiscal stimulus is needed in conjunction with monetary efforts to avoid this scenario.
 - If policy coordination is successful, global equity markets are close to pricing a typical liquidity shock event.
- Moreover, the year-to-date widening in US high yield spreads could reverse, triggered by the implicit Federal Reserve 'backstop' which is currently underpriced relative to the European Central Bank credit backstop.
- Risk management efforts remain critical in light of the credit shock tail risk. Long Swiss franc positions and gold continue to look attractive for safe haven portfolios as do US mortgage backed securities which should be the focal point of further Fed policy action.
 - Risk oriented investors may find opportunities in the recent spike in volatility via asymmetric structured solutions to cushion downside risks while allowing for upside participation.



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Adjusting our framework as the outbreak impacts globally

It is clear that the 2002-2003 SARS outbreak is no longer a basis on which to predict the spread of the COVID-19 coronavirus outbreak. The situation is different given the inability of authorities to restrict the contagion to Asia.

From a single outbreak (centered in China) to now a series of geographic outbreaks, we can see that the evolution of infections outside of China appears to be taking a similar shape in subsequent regions lagged for the transmission of the virus to new geographies. Indeed, using the China experience, it suggests that Korea, Iran, and Italy are in the midst of the 'acceleration phase' that China saw in weeks 2-4 following their initial efforts at containment.

With Germany, France, Spain and Switzerland now appearing to enter a similar phase, stabilisation in continental Europe may only emerge by mid- to late-March. Admittedly, as containment efforts in Europe are less onerous as those seen in China in particular, risk exists that this acceleration phase may extend longer as it moves through the continent than seen in more restrictive regimes in Asia.

Beyond this, with cases in the United States now approaching a critical mass, the risk exists that the Americans may begin a similar process of acceleration in infections in the weeks ahead that might extend into mid-April before stabilisation begins to emerge.

This geographic framework and timeline also suggest that the previous assumption that the economic growth impact of a China-centered outbreak would be limited to the first quarter is misplaced. Instead, given the above timeline as well as the slow ramp up that China is undergoing following the stabilisation of infections, a global economic impact spanning multiple quarters is increasingly likely.

Indeed, with the outbreak in Europe, we have downgraded our global growth forecast to 2.2%, leaving the world economy on the cusp of a global recession. Even this forecast assumes containment which, if it is not achieved in the weeks ahead and an outright pandemic is declared, a full fledged global recession may well be in the offing.

Beware a second round credit shock

Though the extended impact on economic growth was, itself enough reason for the markets to sell off sharply in late-February, potential second round effects may be just as concerning for investors.

In particular, unlike liquidity driven shocks such as December 2018 which are relatively easily repaired by restoring liquidity to the system, the current shock is demand as well as supply driven. As Chinese/Asian supply chains come back online, the

supply issues will slowly fade. Liquidity injections by central banks should be viewed as a necessary component of a solution though not, on their own, sufficient to avert a deterioration in credit markets as companies and individuals find it increasingly difficult to service the high outstanding debt levels around the world.

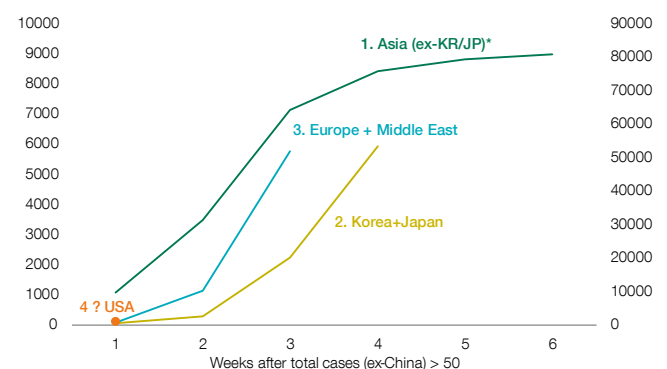
Instead, what is required is a response both from monetary policymakers, as we have begun to see from the US Federal Reserve with its 50 bps cut in rates in early-March as well as from fiscal policymakers. Indeed, rather than the grand infrastructure or tax reform programmes, fiscal authorities should focus on efforts quickly to boost purchasing power to mitigate lost revenue/income as a result of the demand shock. These efforts should extend beyond the already increasing public health spending to combat the virus' spread and focus on payroll tax reductions, and sales/value added/other tax holidays.

When the outbreak occurred, investors were perhaps too quick to assume that it was going to be only China/Asia-centric. They initially drew comfort from the belief that such a local demand shock, even in the second largest economy in the world, could be mitigated due to China's deep arsenal of tools and its ability to restructure, resolve, or absorb domestic credit market stress while supporting the broader economy via fiscal stimulus as it had done many times before.

Now, with a transnational demand shock, the ability for local policymakers to respond in a similar way, both in terms of buying time for companies and individuals to meet their repayment obligations but also in terms of providing financial support to underpin demand within home economies varies from country to country.

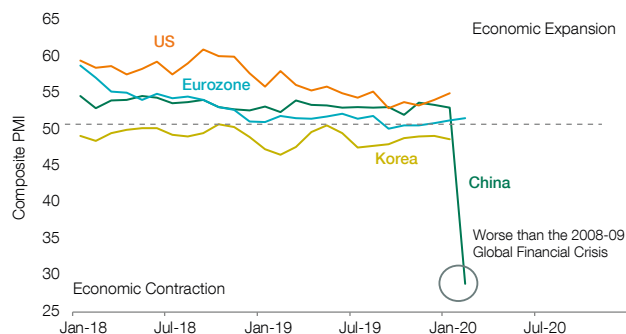
Indeed, the demand shock in Italy strikes at the heart of Europe, where a constrained central bank is paired with a fiscally limited economy before the crisis began. This creates the threat that the virus-driven demand shock transforms into a credit shock, either limited to a particular region or, if not contained, a broader credit contagion across geographies.

Korea, Iran and Europe are in the midst of the viral 'acceleration phase' through mid/end March



Sources: The Vaccine Centre, London School of Hygiene & Tropical Medicine and UBP * Asia ex-Korea/Japan lagged to start of aggressive containment measures in late-January 2020

A sequential economic slowdown is making its way across regions bringing the world to the cusp of global recession



Sources: Markit; Bloomberg Finance L.P. and UBP

Assessing credit shock scenarios on global equities

Unfortunately for investors, we have already had several examples of credit shock scenarios over the past decade to draw from to understand the impact on markets should such a shock emerge.

If our concerns are overstated and the demand shock fails to evolve into even a modest credit shock, equity markets in the major regions of the world have substantially priced in such a temporary demand shock scenario with only <5% downside to price the equivalent of a December, 2018-sized liquidity shock (table).

Should a contained credit event emerge, perhaps in emerging markets or in Europe in light of the current contagion spreading across the continent, 7-15% declines appear possible across major equity regions. It is important to note, however, that the geography of the localized credit event would likely see a more severe decline in markets as seen both in 2011-12 in Europe and 2015-16 in China.

Should global policymakers be unsuccessful at forestalling a wider credit contagion, a minimum of a further 20% decline would be likely with a 2008-09 style environment potentially unfolding.

A modest credit shock suggests a further 7-15% downside in global equity markets

Return potential assumptions (from Feb 28 close)	MSCI US (2,822.38)	MSCI EU (-125.79)	MSCI AxJ (-638.39)
Bottom-cycle PE / Bottom-Cycle ROE	-20.60%	-25.20%	-26.50%
Mid-cycle PE / Bottom-Cycle ROE	-15.50%	-12.50%	-15.90%
Bottom-cycle PE / Up-Cycle ROE	-12.90%	-12.10%	-6.10%
Mid-cycle PE / Mid-Cycle ROE	-7.30%	-4.80%	-4.20%
Up-cycle PE / Mid-Cycle ROE	-1.60%	9.10%	7.80%
Up-cycle PE / Up-Cycle ROE	7.00%	18.00%	21.00%

Credit Contagion (2008-09); Liquidity shock episodes (2018); Contained credit shocks (2011-12/2015-16);

Sources: MSCI; Bloomberg Finance L.P. and UBP * bottom of cycle figures for MSCI US adjusted to account for 2017 tax changes on ROE and PE re-rating **ROE figures for MSCI EU and AxJ reflect de-rating trends since 2000

With these scenarios in mind, given the risks that even a contained credit shock transforms into an outright credit contagion, it is critical that policymakers deploy fiscal AND monetary measures quickly and aggressively to avoid such an outcome.

From an investment perspective, even if such an outcome is not yet a base case scenario, these risks are now non-negligible and must be incorporated into ongoing risk management frameworks.

US Fixed Income markets begin to price in the risk of credit stress

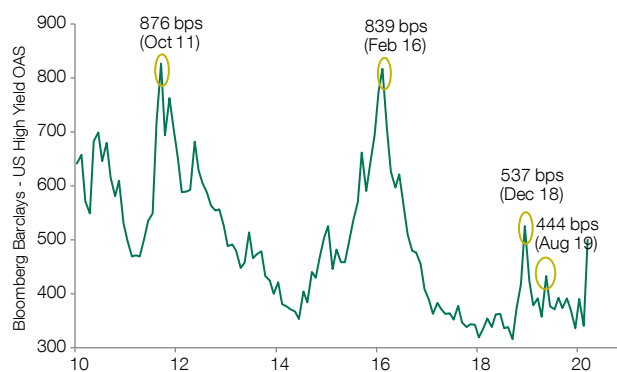
Looking at credit markets, fortunately for European credit investors, spreads on risky European corporate credit have widened back only to late-2019 levels following their sharp decline in December, 2019. This might suggest that concern about credit stress in Europe has increased only moderately.

Perhaps alternatively, it suggests that the European Central Bank backstop that is in place in Euro investment grade credit continues to underpin an implicit central bank backstop in Euro high yield credit markets.

For US investors, spreads of risky US corporate credit have widened meaningfully, reaching just short of the highs seen in late-2018. This suggests investors in US high yield bonds were perhaps more leveraged and forced to exit or more worrisomely, concerns about corporate default have risen more meaningfully, or some combination of the two.

Though spreads remain well short of the levels witnessed during the Eurozone Sovereign Crisis or the US high yield crisis in 2016, we expect the US Federal Reserve will act to contain a credit induced shock in US credit markets as it did following the liquidity shock of December, 2018, providing an implicit backstop to US credit investors. Interestingly, the sell-off in US high yield relative to Euro high yield may suggest greater confidence in the ECB implied backstop than the implied backstop of the US Federal Reserve which we do not believe is reasonable.

USD High Yield credit is anticipating a significant deterioration in credit quality



Sources: Barclays; Bloomberg Finance L.P. and UBP

Interestingly though, USD emerging market debt has not seen similar strains despite the sharp growth shock from many of the emerging economies' main trading partner, China. Moreover, while we expect the US Federal Reserve will act to contain a credit induced shock in US credit markets, outside of China, we do not expect a similar 'backstop' for investors in the broader emerging market universe suggesting risk-reward increasingly favours US corporate high yield relative to emerging market as well as eurozone counterparts, absent the outright credit contagion scenario.

Risk management in the face of a contagion tail risk

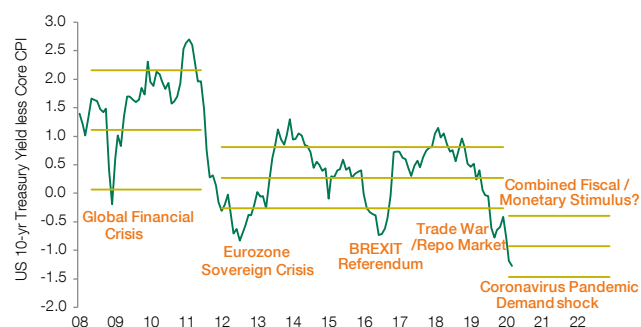
Even should a pandemic / credit contagion scenario not be a base case scenario, we believe the impairment of portfolios that could emerge should this contagion tail risk emerge is significant enough that actively protecting against this risk is critical for investors at this juncture.

As outlined in our February Spotlight, The Viral Demand Shock Goes Global, we have been actively managing a 'risk-off' portfolio within broader portfolios that has helped shield them from the sharp drawdowns in late-February.

Looking ahead, however, many of the measures we have leaned heavily on to navigate this latest bout of market volatility no longer appear to provide the 'asymmetric' protection that they offered as recently as several weeks ago.

In particular, longer duration US government bonds appear to have well priced in an outright demand shock with 10-year yields having fallen below 1% for the first time. With the US Federal Reserve having shown a reluctance to move dollar rates negative and wanting to maintain a positively sloped yield curve, it suggests that further sustained declines outside of an outright credit contagion scenario are unlikely.

US risk-free yields have already priced in a COVID-19 demand shock



Sources: Barclays; Bloomberg Finance L.P. and UBP

For investors seeking a long duration US Treasury alternative, the Fed may need to revisit its 2008-09 foray into the US agency mortgage market where agency mortgage spreads - at near 50 bps currently - sit at the widest levels since 2013. In 2010, at the height of Fed purchases of mortgage backed securities, this spread compressed to effectively zero against comparable Treasuries.

In addition, we continue to see opportunities for investors in safe haven currencies. In particular in Europe, we expect the Swiss franc to continue on its appreciation trajectory against the Euro towards parity as well as the US dollar, providing cushion for investors amid uncertain markets.

We continue to view gold as an excellent anchor for portfolios looking ahead. However, the lackluster performance of gold during the height of the February market volatility was surprising to many. We believe that, as speculators were unwinding leveraged positions across asset classes in the midst of the selldown, the leveraged long, speculative positions in gold were unwound as well providing a headwind to gold investors during this risk off period. In spite of this, we expect that in a credit contagion scenario, physical gold will retain its attractive safe haven properties.

With volatility having spiked to near 10-year highs, the cost of protection via the options market has risen sharply. As a result, we expect we will increasingly reduce our reliance on near at the money options protections for portfolios in favour of out of the money strategies to continue to protect against a credit contagion tail risk outcomes.

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